Economic Analysis of Governor Warner's Budget and Tax Reform Plan

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Virginia Department of
Planning and Budget
Division of Economic and
Regulatory Analysis

Executive Summary

Introduction

In late November, Governor Warner announced a tax reform plan that makes several changes to the overall tax structure in Virginia. The key features of the plan include:

- *Individual Income Tax*: Raising the personal and dependent care exemption, the standard deduction, and filing thresholds as well as making adjustment to the tax brackets and rate structure for the state's individual income tax;
- *Sales and Use Tax:* Reducing the sales tax on food by 1.5 cents and adding one cent to the sales and use tax;
- *Corporate Income Tax:* Changing business tax provisions with respect to intangible holding companies, pass-through entities, and sales of goods shipped from Virginia to other states;
- *Cigarette Tax:* Increasing Virginia's cigarette tax from 2.5 cents per pack to 25 cents per pack with all of the proceeds dedicated to paying for health care, while also giving localities the ability to levy an additional tax, up to a phased-in maximum rate of 50 cents per pack;
- *Car Tax:* Phasing in the completion of the car tax relief program by calendar year 2008, subject to the same revenue growth triggers as currently specified in the Code of Virginia;
- *Estate Tax:* Eliminating the estate tax for closely held businesses and working farms as well as imposing the tax only on estates valued in excess of $10 million after January 1, 2004;
- *Accelerated Sales Tax Collections:* Ending the accelerated payment of sales taxes in June 2005;
- *Business Incentives:* Conforming to federal tax provisions which allow businesses to deduct as business expenses up to $100,000 in equipment or similar purchases each tax year (compared to the current limit of $25,000);
- *Age Deduction:* Restructuring the age deduction provided to seniors in the future while grandfathering the tax benefit to current senior citizens;
- Providing tax relief to military, reservists, and National Guard families by conforming to recent federal tax provisions; and,

- Adopting the Streamlined Sales Tax statute (without the sourcing rules) effective July 1, 2006.

The provisions of the Governor's tax reform plan have since been incorporated into his proposed budget recommendations for the 2004-2006 biennium. Subsequently, questions have been raised about the economic impact of various features of the plan. The purpose of this study is to assess the overall economic impact of both the tax reform and budget proposals on the Virginia economy.

Methodology for Study

Governor Warner's tax reform and budgetary proposals involve a combination of changes to the tax code as well as changes to the level and mix of state expenditures. Making a reliable numerical estimate of the net impact of this package of policy initiatives requires a great deal of information about difficult-to-measure aspects of consumer and business behavior. For example, the proposed changes in the sales tax could alter the types of goods purchased. The reduction in the estate tax could boost business formation and survival in Virginia and increase capital expenditures both inside and outside of the state's borders. Changes in the cigarette tax could affect the number of children who choose to take up smoking and ultimately public health costs. There are many complex factors to be accounted for.

Moreover, even if one could identify all of the important responses by the various affected parties and make credible estimates of the likely magnitudes of those responses, the results would have to be knitted together into a mathematical model that accurately reflects the relationships between all the various players in the economy. This model would have to be stable enough to remain relatively accurate in its assessment of the economy in good times and bad. Because current six-year financial plan required in the Code of Virginia projects continuing budget shortfalls at least through the end of the 2008-2010 biennium, the model should also be able to accurately assess the economic impact of various options for addressing the shortfalls, including budget reductions. The model must also be carefully calibrated, or fit, to the actual circumstances and relationships in the Virginia economy in a way consistent with sound economic theory, requiring enormous attention to detail.

To assess the economic impact of Governor Warner’s tax and budget reform proposal, the four staff economists in the Economic and Regulatory Analysis Division of the Department of Planning and Budget conducted an intensive review and analysis of 155 different economic studies conducted in recent years. For each change to the tax code and each budgetary proposal, staff economists identified as many of the relevant studies as could be found in order to evaluate the quality and relevance of the study to each of the Governor’s proposals, and to use this body of work to draw inferences and conclusions about what is known and about what, with any confidence, can be said and cannot be said.

At the outset, it is acknowledged that for any fair reading of the literature, there is a wide range of estimates for the measures of responsiveness and impact to tax policy changes, as well as changes in governmental spending. Generally, it is not possible to conclude that one study is better or worse than another, only that different measurement experiments have enough differences in data collection or design to produce significant variation in results. However, based on the entire scope of this collection of findings and results, staff have drawn reasonable conclusions about the weight of the overall evidence presented herein. These are outlined below.

General Conclusions

Governments generally use tax policy to influence private behavior (e.g., private investment) or to raise sufficient revenues to pay for spending on public goods. It is within the context of these behavioral changes or monetary flows that fiscal policy affects economic activity.

Some of the activities of government are simply transfers of income from one set of citizens to another. These transfer payments, whatever their motivation, can be expected to have little net impact on overall economic activity in the short run. Over longer periods of time, the existence of the transfer payments can have a larger impact due to the responses of individuals in the economy to their new set of economic incentives.

Other activities of government are intended to address circumstances where a collective judgment has been made that markets operating on their own may not be able to provide an optimal level of certain important goods or services. Education, transportation, and indigent medical care are three such areas. The governments of all developed economies invest substantial resources in each of these areas.

As with private economic activity, it is almost certainly true that (1) not all expenditure plans are equally productive, and (2) government expenditures in the otherwise productive areas eventually become subject to diminishing marginal returns as the expenditures increase relative to the size of the economy. Given these assumptions, it follows that, to judge the economic effectiveness of any governmental plan for raising and spending funds, it must be determined whether the planned expenditures are well targeted and whether the level of expenditures is likely to be past the point of rapidly diminishing returns.

Similarly, the various sources of revenue do not have the same impact. Different sources of government revenue have different effects on economic activity in the short run and on into the future. As one of fifty states embedded in a highly integrated national and international economy, Virginia must consider the relative mobility of capital, people, and resources when considering methods for raising revenue. To the extent that revenue actions induce unproductive tax avoidance behavior or the movement of resources out of the state, taxes can impose an additional burden on Virginians. A well-crafted revenue plan, however, can keep the additional resource costs of taxation to a minimum.

Specific Conclusions

> 1. The changes proposed in the Governor's plan to the individual income tax reduce the tax payments made by lower and middle-income earners, while raising the rate on approximately four per cent of the top income earners. Given the modest size of the increase and given that Virginia's top effective rate for that bracket remains lower than in Maryland, North Carolina, and West Virginia, it is anticipated that the increase in the top

bracket will not cause a significant reduction in economic activity. This is especially true since the reduction in tax payments in lower income brackets will provide some short-run stimulus to the state's economy.

2. Evidence suggests that the reduction in the estate tax may have a significant positive effect on capital formation and investment in Virginia. This will be balanced, to some extent, by reduced charitable contributions by those previously subject to the estate tax.

3. The increased deductions for business equipment provide a stimulus for investment while the implementation of the throwback rule works in the opposite direction. Initial analysis suggests that the throwback rule will have a relatively small impact on most firms while the effect of increased deductions will be more widespread. This suggests that the changes to corporate taxes may, on net, have a positive impact on economic activity.

4. Because the reduction in the personal property tax is paid for one-for-one with other tax revenues or spending reductions, its main effect will be on increasing the relative attractiveness of spending on cars relative to other consumption goods. This will not have a significant net effect on Virginia's economy.

5. The increase in the sales tax rate on non-food commodities along with the reduction in the rate on food results in a net increase in state revenues. Since the revenues from the increase are proposed to be spent principally on education, transportation and Medicaid, the change would only produce a net drag on the economy if the economic impact of the rate increase is significantly higher than the impact of the resulting spending programs. However, it should be noted that Virginia's sales tax rate is generally lower than other states in the region, even after the proposed rate increase. In addition, available studies do not support the contention that the negative economic response to a sales tax increase is likely to be greater than the response to increased spending on infrastructure and education. In fact, it seems clear, based on available evidence, that a spending plan

focused on higher rate-of-return programs stands a good chance of providing a significant net economic gain for the state economy.

In addition, while the proposed increase in the sales tax does increase sales tax payments by lower income families, the increase is relatively small, and to some extent is offset by changes to the income tax. This impact is further offset by increased spending on indigent medical care services and support for public education. Lower income families will benefit disproportionately from Medicaid spending and from support for K-12 education in Virginia.

6. The cigarette tax, unlike other taxes, could conceivably produce a net economic benefit in its own right. If, as some studies conclude, smoking generates a net drag on economic activity due to its harmful effect on productivity and on public expenditures on health care, then any reduction in smoking due to the tax increase would actually have a positive net economic impact. Even if the benefits of a reduction in smoking do not fully offset the impact of the tax increase, they do ensure that increases in the cigarette tax from its current low rate will have considerably less impact on the economy than an increase in other sources of revenue.

As already mentioned, a comprehensive and credible economic impact assessment of the Governor's proposals should not analyze the effects of his tax policy changes without also addressing the likely benefits of the spending supported by the increased revenues.

7. There is strong evidence that expenditures focused on the quality of K-12 education, especially expenditures that result in lower class sizes and improved teacher quality, can significantly improve student outcomes. Corporate surveys have consistently shown that the availability of skilled labor is the most important factor in choosing site locations. Through increased productivity and increased business investment, expenditures on education produce significant growth in employment and per capita income. Investments in top-ranked academic research with respect to science and technology is also known to be associated with increased private investment in those areas.

8. Traffic congestion can add significantly to the cost of doing business in Virginia. By hurting productivity, congestion eventually reduces the level of capital investment in the Commonwealth. A safe modern transportation infrastructure is an essential state contribution to business productivity and competitiveness; and is vital to maintaining Virginia's reputation as a great place to live and work.

9. The Medicaid program does more than provide immediate medical assistance to indigent families. Through the 50% federal match on every dollar of state spending, Medicaid pumps hundreds of millions of dollars in federal spending into Virginia's economy. In addition, there are big hidden costs to not providing basic health care to indigent families. Uninsured low-income families receive less preventive care, are diagnosed at more advanced disease stages, and once diagnosed, tend to receive less therapeutic care and have higher mortality rates. These costs are paid for by all Virginians and often with no federal matching dollars. Providing basic health care to poor families materially contributes to the health of the Virginia economy.

10. The balance of the available economic evidence suggests that, up to a point, targeted spending on transportation, education, and Medicaid can improve both short and long run economic growth and employment. This set of proposed expenditures supported by the increased revenue in the Governor's proposal represent modest increments to the state's long-standing commitment in all three areas. As such, the additional expenditures in these areas have a good chance of providing a significant positive impact on economic growth through contributions to competitiveness, employment, and per capita income.

After reviewing the results of various published research efforts on the economic impact of fiscal policy changes, the evidence supports the conclusion that the various tax reductions and the additional expenditures targeted to improving Virginia's business climate – through improvements in education, Medicaid spending, and transportation – will outweigh any plausible negative effects from the proposed change in the sales tax and the increase in the top bracket of the income tax.